

Zhou Xiaochuann: Preventing future accumulation of large NPLs by the commercial banks after the present round of reform

Speech by Mr Zhou Xiaochuann, Governor of the People's Bank of China, at the China Summit of the 7th Beijing International Science Industry Expo, Beijing, 21 May 2004.

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Ladies and Gentlemen:

This Summit is a very important meeting. I appreciate this opportunity to share my observations with all of you. The topic I am going to talk about relates to one of the functions of the institution I am working for, which is how to prevent the commercial banks from accumulating new NPLs after the present round of banking reforms.

The answer to this question and the resolution to the problem involve systemic engineering. To solve this problem the utmost is that the commercial banks must take measures themselves to make sure large amount of NPLs will not be accumulated in the future through strengthening internal reforms and putting into place good institutional mechanism. Internal reforms refer to establishing good corporate governance, setting up internal control system and risk management system, optimizing credit procedures, updating the information system and establishing clear internal incentives of reward and punishment schemes. The purpose of these reforms is to develop an effective new mechanism to help commercial banks avoid accumulating large amount of new NPLs. Representatives from the commercial banks must have deeper thoughts on this issue and should be invited to speak on this topic. My speech today will focus on aspects of reform that goes beyond the internal reforms of commercial banks and which cannot be accomplished by the commercial banks alone but rather with the crucial help from other institutions and the whole society.

I am going to talk about the following issues:

1. Reforms of commercial banks' customers, especially those in the corporate sector.

After the structural change at commercial banks, the task of avoiding accumulating large amount of NPLs, to a large extent, depends on the reforms and overall quality of their customers. In recent years, despite the fact that the consumer lending and housing mortgage lending are in a surge, the major client group of the commercial banks are enterprises that involve in different lines of business and are of varied ownership. Whether the commercial banks can prevent large amounts of new NPLs from occurring will hinge on the success of enterprise reforms. Only when the enterprises improve their operation and profitability, can they strengthen their ability to repay debts, which will lead to lower loan default rates and low NPL ratios.

Banks face different clients under different market conditions. In a mature market economy, bank clients are of good quality and a credit culture is well established in the society. This in turn makes it possible to maintain relatively low NPL ratios. In a transitional economy, it takes time for the credit culture to be established and for enterprises to improve their quality. As a result efforts from the whole society are required.

In the reform process, when applying for loans, enterprises should be required to provide true, reliable and complete information, which include not only financial statements and the organizational structure of the enterprise but also the true purpose of borrowing. For specific projects, the borrowing enterprise should also be required to provide true information about the projects. In practice, there have been cases where the enterprises provided false information to banks in order to swindle bank loans. False information can take the form of manipulated financial statements, which depends on whether accounting standards are appropriately applied and whether there is independent auditing. False information can also take the form of the fraudulent information about the projects to be financed. Recent fall-outs of a few enterprises reveal that before being exposed they had taken advantage of complicated, non-transparent company organizational structure unknown to other people and a complicated controlling structure to conduct connected borrowing through varied channels of financing they controlled or through obtaining shares at a number of financial institutions or quasi-financial institutions. From a legal perspective, using false information to defraud financial facilities from banks

or other non-bank financial institutions is illegal. Laws and regulations that can discipline and punish such acts should be put into place.

The second aspect of enterprise reform is to quicken the steps of reform to build up enterprises' capital. Generally, enterprises with inadequate capital pose a serious problem. Even though the situation has improved compared to that in the early half of the 1990s, the enterprises' own capital still remains at a low level in regard to the rules of market economy. This situation not only reflects the financing structure of the whole society but also closely relates to the progress of enterprise reforms. In a society where indirect financing is dominant, the first problem caused by low capital level is the high leverage ratio, which implies relatively low risks for borrowing enterprises and high risks for banks. In this regard, good risk management requires the banks to find out the proper leverage ratios for different enterprises under different circumstances. If the enterprises fail to undertake necessary reforms, it would be difficult for them to raise capital to appropriate levels. As a result, enterprises would take on high external leverage ratios and expose banks to greater market risks and potential NPL risks.

The third aspect is that attention should be paid to factors that affect normal default rates. Since risks are inherent in all markets, in ordinary business activities enterprises may make investment mistakes and be subject to risks in the market. This creates default risks for their banks. Defaults due to the play of market risks are related to the location, the industry, the scale and the share-holding structure of enterprises. Normal defaults are unavoidable. So attention should be given to differentiate the normal and abnormal defaults. The default rates in economies in transition are different from those in market economies. As a developing country, China's default rates are similar to those in other developing countries. In emerging market economies, the default rates are subject not only to the workings of market risks but also to abnormal institutional factors which are sometimes installed by administrative intervention. An ordinary enterprise that is capable of servicing its debt may be liable to default under administrative intervention. In the same vein, the default rates may also be excessively high in a unsound legal or regulatory environment. In other words, if the conditions under which the banks clients are operating remain unchanged, the default rates may be higher than normal levels due to market risks as well as complicated institutional factors. If such factors are not addressed, it remains possible for commercial banks to incur large amount of non-performing assets.

Furthermore, the enterprise reforms are conducive to strengthening budget discipline, which usually determine the ability of enterprises to repay their debts and thus directly affect NPL level at banks. The budget discipline of enterprises has evolved from a soft budget constraint in the 1980's to a much harder one now. Further progress in this regard will have a bearing on the development of NPLs.

2. The development of NPLs will be closely related to progress in market-based interest rate reform.

You may have noticed that many of the Party and government documents have listed gradually moving toward market-based-interest rates as one of the directions and objectives of financial reform. Although in the recent past the bands of interest rates fluctuation have gradually widened, they are not determined solely by market conditions.

The relation between interest rate reform and NPLs is reflected in the discretion banks have in pricing loans. In a market economy, the prices of loans vary due to the cost of funds, credit rating of the borrowers and the outlook of projects to be financed. Since risks are always present in commercial activities, the different risks of different borrowers and their different projects should be offset by different risk premiums charged. This requires the commercial banks to charge interest to offset and cover the risk premiums, which is also for the purpose of absorbing losses from defaults which have low probability of occurring and account for only a small portion of the total loans. The nature of banking business is to take deposits, issue loans and make profits out of interest spreads. Not all loans issued can be recovered. There is always a percentage of loans that result in losses and need to be absorbed by higher interest rate income. Thus, it is crucial for banks to be able to decide on the prices charged to different clients so that they can prevent large amount of NPLs from forming or be able to dispose of them. If a one-size-fit-all interest rate is charged to different types of enterprises, the loss of some risky loans would not be covered. If accumulated, even losses on a small scale could evolve into large amount of NPLs. In sum, the progress of interest rate reform will have a bearing on the source and disposal of NPLs.

Market-based interest rate should not only be reflected in pricing of loan products and other assets, but also be extended to pricing of all kinds of services and deposits. In absence of good customers, the commercial banks could adjust their business strategy in two directions: one is to reduce activities on the asset side and expand business on intermediate service, which surely involves pricing of services; the other is to cut business on both the liability side and the asset side. Active management of the liabilities, either expansion or reduction, would surely require commercial banks to exercise discretion in pricing products on the liability side of the balance sheet, including deposits. In this regard, deposit interest rates shall remain flexible too.

3. Commercial banks shall be allowed to make full provisioning and write off losses. The related tax policies shall be revised accordingly.

Bank loans are always subject to a certain degree of economic risks, and at some stage of business operation, the financial risks faced by banks are rather high. The commercial banks have to rely on operational income and profits to offset losses. We can see that in mature economies, banks are required to put aside all kinds of reserves, including risk reserves and others to guard against different types of risks.

In the case of China, for a long time, commercial banks were not allowed to make full provisioning. One reason was that the reforms of commercial banks had not been completed. The other was that there was a lack of financial resources. It was not until mid 1990s the practice of provisioning was overhauled. However, generally speaking, the proportion and scale of provisioning are insufficient, implying that commercial banks are not financially strong enough to write off all of the bad loans. As a result, only a small portion of the bad loans was written off and overtime, large amount of NPLs has been accumulated. In order to prevent this from happening again after the reforms, commercial banks should build up loan reserves based on stricter accounting rules and loan classification standards and be given discretion to write off losses in a timely manner.

Directly relating to loan provisioning is the reform of relevant tax policies, which involves tradeoffs between the state interests and the sound development of the banking sector. Banks in China are levied not only the corporate income tax but also the unique business tax. If provisions are included in the taxable income, commercial banks are subject to heavier tax burden and their ability to absorb NPLs is weakened.

4. Markets to trade risk products and non-performing assets should be developed.

Just as Mr. Schwab has talked about a while ago, in order to help identify risks in bank assets, price and transfer risks through normal transactions, we need to develop a market where risk products can be traded.

In a typical market for risk products, the products traded are mainly CDS (Credit default swap) and CDO (collateralized debt obligation). Through buying and selling risk products, the probability of default is priced and traded. If such risk products are absent or a market where such products can be traded is absent, it would be difficult for the banks to efficiently identify risks and estimate the potential scale and value of loss if defaults materialize. In such circumstances, the commercial banks cannot sell the risks they want to part with in managing their balance sheets. Meanwhile, institutions that have financial resources and are willing to bear higher risks so as to receive higher returns, would find it difficult to buy such risk products. In this regard, a risk product market is required to facilitate commercial banks managing their risks.

Similarly, for the NPLs already accumulated by the commercial banks, a market to trade NPLs needs to be established to facilitate disposal of NPLs according to the market rules. After the Asian financial crisis, four asset management companies were set up in China in 1999 to dispose of the NPLs removed from the books of four state-owned commercial banks. Foreign investors and domestic institutional investors have been encouraged to get involved in disposing of NPLs. With these developments, the NPLs transfer market is forming and developing. The existence and maturity of such a market is crucial for the banking sector to solve the historical NPL problem.

5. Measures should be taken to encourage the development of a variety of service intermediaries necessary for the growth of the banking sector.

The development of the banking sector requires the support of a variety of highly specialized intermediaries. When banks screening customers, they need accounting firms to audit the financial situation of these customers; when providing sophisticated financial services, they need law firms to verify and justify the legality of the business of their customers; when estimating customers' assets, they need professional asset quality estimators to determine their value; when conducting asset management through transactions of financial securities, they need rating agencies to rate the financial products for the purpose of pricing these products.

It is common understanding that the growth and development of these specialized intermediaries will contribute to the development of capital market. From the perspective of developing the banking sector, for the commercial banks to improve asset quality and effectively prevent the NPLs from growing, we must place enough emphasis on the role and development of specialized intermediaries.

Usually, it takes a long time for the specialized intermediaries to grow and develop and often involves complicated issues. Given the time constraint and that I have spoken about this issue on earlier occasions, I will not further explore it. What I would like to emphasize is that we need to adopt a more open attitude toward fostering the development of domestic intermediaries on the one hand, and further opening the service sector and tapping external resources on the other. As a result, there will be more high quality, accountable and specialized service providers in the credit market.

6. Consideration shall be given to removing the institutional barriers in the process of improving corporate governance.

In the process of commercial bank reforms, many have stressed the importance of corporate governance. It is noteworthy that in addition to the efforts by the commercial banks and their shareholders, we should also consider whether there are some inappropriate policy constraints that relate to our thinking and traditional practice.

As have been mentioned by Mr. Schwab, the concept of corporate governance has evolved into the concept of international corporate governance that originated from a research on the subject by the OECD in the early 1990's. Later the OECD released Principles on Corporate Governance. Although the five principles are general guidelines, their implementation in China would encounter a few institutional constraints. The expressions of some concepts are not applicable, such as the issue of conflict of interest. In addition, there are some remaining administrative approvals, and institutional and organizational arrangements that continue to hamper the development and improvement of corporate governance. Following this vein, based on the common understanding of the importance of corporate governance, we need to consider what the institutional constraints are and how to remove them in order to establish good corporate governance.

7. In order to effectively prevent large amount of NPLs from being accumulated at the commercial banks, actions shall be taken to smooth out business cycles.

Indeed, the biggest concern for banks is the ups and downs of the macro-economy. When the economy is in boom, it is apparent that banks are in good conditions with handsome profits and better asset quality. For example, in recent years all of us have seen that the NPLs of the state banks were being reduced by 3 to 5 percentage points every year. However, once the economy experiences ups and downs, especially during the down times, the encouraging trend might reverse and it is likely that large amount of NPLs may emerge and make the situation difficult to manage. Similar situations occurred before and after the Asian financial crisis as reflected in the NPL data of Thailand, Korea and Singapore, where when the economies began to plunged into recession, the ratios of NPL rose sharply.

In a market economy, the fluctuations in the business cycle are inherent. In transition economies, the fluctuations in business cycles cannot be avoided completely. In this regard, the commercial banks shall establish a capable macroeconomic research team, which can help make good judgments about the coming shifts in the business cycle so that proactive measures can be taken to guard against potential risks. In China, during the period of planned economy, the interest rates were set by the state. The commercial banks and insurance companies regarded their losses due to the interest rate changes being incurred by the related state policies. This perception has become out of date now. In a

market economy, the commercial banks as well as non-bank financial institutions must be capable of predicting future economic fluctuations so that good performance can be achieved during booms and risks be hedged during fluctuations. The commercial banks should especially consider how to improve their work in this regard.

Here, I would like to cite an example. Two or three years ago, inflation in China was so low that there was even a deflation. The Ministry of Finance issued 10-year and 30-year bonds with very low rates. A number of big commercial banks purchased these bonds. Retail investors were not able to predict future interest rate development due to limits in research ability. However, the big commercial banks should have strong analytical capacity. If they also bought these bonds at a very low price, it might indicate that they had not assessed the long-term risks adequately. This is an issue they should pay attention to.

From a macroeconomic perspective, to prevent the economy from experiencing stop-and-go cycles, in addition to deploying the appropriate monetary policy tools at appropriate time, we should especially stress the importance of avoiding asset bubbles. Once bubbles have formed, it is difficult to make adjustments. This is exemplified by what has happened in Japan. That is why we are going to do our best to prevent asset bubbles from occurring. For China as well as for the rest of the world, the greatest concerns lie in the asset bubbles in the equity and real estate markets. However, in China the bubbles may occur in a different form, in that they may occur in the manufacturing industry, processing industries or the raw materials in the form of excess capacity in production. If excess capacity exists, the investments and consumption ratios and their proportion in regard to GDP would appear disproportionate. In this regard, doing a good job in macroeconomic adjustment and aggregate analysis will help the commercial banks not only to identify future risks, but also avoid accumulating NPLs in economic downturns through mitigating fluctuations in business cycles.

Even though there are many more aspects that can be discussed on this topic, I have only focused on the above seven points. Another interesting topic is building a society-wide credit system. Since I don't have much time, I will not dwell on this topic. It is noteworthy that, sometimes even commercial banks' internal reforms require support and assistance from outside. These reforms include how to retain quality staff, how to develop effective incentive schemes, how to establish a favorable environment that foster fast growth of good institutions and force poor ones to undertake reform, and how to help the commercial banks to compete domestically and internationally when our commitments to the WTO come due. All of these topics require in-depth research.

Thank you very much for your attention.